

1998

# Comment letters, deferral of the effective date of certain provisions of SOP 97-2, Software revenue recognition, for certain transactions;

People Soft Bankers Systems

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## Recommended Citation

People Soft Bankers Systems, "Comment letters, deferral of the effective date of certain provisions of SOP 97-2, Software revenue recognition, for certain transactions;" (1998). *Statements of Position*. 643.  
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**Comment Letters Received on the  
February 11, 1998 Exposure Draft,  
Deferral of the Effective Date of Certain Provisions  
of SOP 97-2, Software Revenue Recognition,  
for Certain Transactions**

<b>Letter No.</b>	<b>Commentator</b>
1	People Soft
2	Bankers Systems Inc.
3	Ernst & Young LLP
4	Deloitte & Touche LLP
5	Francis J. O'Brien
6	Committee on Accounting Principles of the Illinois CPA Society
7	Price Waterhouse LLP
8	Microsoft Corporation
9	Software Publishers Association
10	Arthur Andersen LLP
11	Lucent Technologies, Inc.
12	Symantec Corporation
13	Coopers & Lybrand LLP
14	Scopus Technology, Inc.

**PeopleSoft**

**4305 Hacienda Drive  
P.O. Box 8015  
Folsom, California 94608-8015**

**Alfred J. Castino  
Vice President of Finance and Chief Accounting Officer  
PeopleSoft Inc.  
Phone: (510) 468-2854**

# /  
**FEB 25 1998**

February 24, 1998

**Mr. Frederick Gill  
Senior Technical Manager, Accounting Standards  
AICPA  
Accounting Standards  
File 2354.WG  
1211 Avenue of the Americas  
New York, NY 10036-8775  
City, State/Province Zip/Postal**

Dear Mr. Gill:

On behalf of PeopleSoft Inc., I wish to respond to the exposure draft of the SOP entitled: Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition.

First of all, let me introduce PeopleSoft. We are a major supplier of enterprise management and administration software, with revenues in 1997 of over \$800 million, substantially all of which were derived from direct sales and support activities. Our sales transactions are typically large contracts which average over \$1 million in total value, and which include software licenses, installation, training, and first year maintenance. Each of our licensing transactions are evidenced by a detailed, written contract. Although we are a very innovative technology company, our accounting practices are very conservative. Our year end financial statements included over \$325 million of deferred revenue, which relative to our trailing twelve month recognized revenues, is far higher than most companies in the enterprise software industry.

We applied SOP 97-2 in its draft form throughout 1997. We consulted closely with our audit firm, Ernst & Young LLP, in applying the draft SOP, and we changed some business practices to ensure that we were in conformance with the SOP in all respects. We believe that the SOP itself contributes positively to the accounting standards of our industry; in fact, our own accounting practices prior to 1997 did not differ materially from those in SOP 97-2, and, quite frankly, we are pleased to see that our competitors and other firms in our industry must now move to a more conservative basis for revenue recognition.

I support the deferral of the effective date of paragraph 10 with respect to establishing vendor specific objective evidence for first year maintenance that is bundled into the price of the software contract. We bundle such first year PCS into our software sales contract; nearly all of our customers renew their maintenance for an established price each subsequent year. I feel strongly that the second and subsequent year maintenance pricing does indeed establish vendor specific objective evidence of fair value for the first year maintenance. The services included in second and subsequent year maintenance are identical to the first year: software updates, account management services and customer hot line support. In the absence of the new exposure draft, we would need to separately charge for first year maintenance, a complication of our contracting activity that would be purely form rather than substance.

I would also like to comment on other issues that are not addressed by the exposure draft. Frankly, the software industry and the Big Six accounting firms seem to be in turmoil today as they attempt to apply SOP 97-2. Our audit firm has recently brought to our attention verbal interpretations from the Big Six (and supposedly the SEC) which, I believe, go significantly beyond what is written in SOP 97-2, and in

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some cases these interpretations seem to directly conflict with what was written in the SOP. I believe that more specific implementation guidance is required in order to ensure that the SOP is interpreted and implemented according to your original intent.

I know of nothing that has been written by any of the Big Six firms or the SEC that raise these new issues, but they are being verbally communicated by the various firm's audit staff to their clients. I want to bring to your attention some of the most troubling examples:

- If a software firm's marketing literature or other communications (e.g. speeches, items posted on a web site, etc.) describe future product plans or directions, the company may have to defer all software sales revenue until such functionality is delivered. Apparently, the concern is that the customer is actually buying such future functionality rather than what is being delivered today, despite what is stated in the contract. In our case, our contracts are very clear about what releases are included in the sales contract. In addition, in the case where a future function is extremely important to a customer such that it may impact the customer's future use of the software, our practice is that the contract makes it very clear that such function is available only on an if and when available basis, and there is no guarantee such function will ever be delivered. We then defer the revenue on the module in question if we have clear VSOE, or if we cannot establish VSOE for that module, we defer revenue on the entire contract. If, on the other hand, the customer is willing to accept a contract with no reference to future functionality they may have seen in marketing literature, I believe that is strong evidence that they understand what they are buying and are not relying upon future functionality in making their buying decision. In these situations, the customer will utilize and pay for the current version. Certainly our history of customer payments supports this argument. I believe our current practice is entirely consistent with the SOP, while the new interpretation directly contradicts paragraph 16 of the SOP which states:

"If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties."

- Products which typically require updates whenever state or federal rules or regulations, or other external factors, change, must be accounted for on a subscription basis, even though customers may pay maintenance charges to receive such updates. An obvious area where this applies to PeopleSoft is in the payroll application modules we license, and the associated provision of regular payroll updates incorporating the most recent tax law changes.

Again, I believe this is not consistent with the SOP. Paragraphs 48 and 49 describe such subscription accounting in the case of unspecified additional software products. The updates described above are not new products, they are simply updates, and the updates are necessary to simply keep the software compliant with its specifications. These updates are covered by maintenance in the same way as other unspecified product upgrades. Customers who elect for any reason not to renew their annual maintenance and support agreements will not receive any further system updates following the expiration of their preceding support period. Warranties made to a customer to keep a product current to published specifications, in relation to external factors the vendor and the customer do not control, should not constitute specifying an upgrade. There should be a distinction in the implementation guidance between updates warranted to keep the product current and compliant with its specifications versus upgrades that might be warranted to increase its future functionality and remain competitive.

- Many commercial and government procurement rules often require that the Request for Proposal (RFP) be attached to the final contract, along with the vendor's reply to the request. Such RFP

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documents often question future product direction. Recent verbal interpretations state that if such RFP's exist, whether or not they are attached to the contract, then the RFP itself constitutes a specified upgrade. This would be the case despite any language in the contract which may state clearly that such future product functionality is not included in the sale, nor is there any commitment to deliver such functionality at any point in the future. Again, I believe this directly contradicts paragraph 16 of the SOP. The fact that the customer states in the contract that they are agreeing to acquire, utilize, accept, and pay for the current version of the software without relying upon any future upgrades discussed in the RFP, is a strong indicator that the customer does not require those future updates and is not relying upon them in signing in the contract. Again, our payment history from customers supports this argument.

- A recent verbal interpretation states that a vendor cannot establish vendor specific objective evidence of value unless it adheres to a rigid pricing model which can establish the price charged to any customer down to the dollar, including the discount rate from list price. Such a pricing model would be based upon whatever factors the company considers in determining the price. If such a precise pricing model cannot be established, then vendor specific objective evidence of value cannot be established, leading to most revenue being deferred. I believe the vendor specific objective evidence must allow for a reasonable range of variation from the model's computed price, reflecting the value the customer receives from the product and the competitive situation. I see no reference in the SOP whatsoever that seems to require a "down to the dollar" pricing model, including paragraph 103 in the basis for the conclusions.
- In the case of enterprise software, customers usually buy a suite of modules rather than simply one product. For example, a customer typically would not buy only a general ledger product; they also would usually buy a few others such as accounts payable, accounts receivable, fixed assets, etc. The recent verbal interpretation we are hearing is that a firm can never establish vendor specific objective evidence of value if a product is sold with another product, regardless of the correlation of the pricing model and pricing history, since the module is not sold separately.

I believe that if individual products are within a group of products which are sold for a price that clearly correlates to the prices of the individual components in the pricing model, the vendor can indeed establish fair value for each module. This is the case since the vendor can show that the pricing for the group of products does indeed vary based upon the inclusion or exclusion of individual modules. I believe the vendor's evidence supporting this correlation of fair value should constitute vendor specific objective evidence of fair value.

If the new interpretation prevails, we would need to start selling each module separately, with a separate contract for each, again a large increase in business complexity to achieve accounting form over substance.

- In the quarter preceding a new release of software, revenue recognition for any shipments of the current release are not allowed, given that the customer is likely to desire the new release which is not yet available.

Here again, I believe this directly conflicts with SOP paragraph 16. Our written contract clearly states what software is being purchased with the current contract, and future updates are covered by maintenance.

This is probably not an all inclusive list of all the various interpretations which are swirling through the Big Six and the software industry. I have not seen any written interpretation from any of the major accounting firms, leaving the software industry in turmoil as we try to implement the new SOP. The lack of such written implementation guidance makes it extremely difficult for any software firm to provide

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accurate guidance to the investment community regarding its anticipated results of operations or trends.

The uncertainty surrounding the interpretation and practical implementation of SOP 97-2 is of great concern to us. In fact, this uncertainty led us to conclude that it was both prudent and appropriate to prepare and disclose a risk factor in our latest quarterly earnings announcement which essentially described briefly some of these uncertainties. Investors in public equity securities, particularly investors in technology companies, must make their investment decisions in the face of significant risks and uncertainties which are inherent in dynamic industries. It is extremely disappointing to us that uncertainty surrounding the interpretation of an accounting pronouncement unnecessarily adds to their existing risk burden.

I urge the Accounting Standards Executive Committee to issue detailed implementation guidance in response to the significant issues which are being raised today by the major accounting firms to their clients. I recommend that you delay implementation of SOP 97-2 pending development of such guidance.

Sincerely



Alfred J. Castino

# 2

**Bankers Systems Inc.**

Box 1457 • (320) 251-3060  
St. Cloud, Minnesota 56302-1457

**FEB 25 1998**

February 25, 1998

Mr. Frederick Gill  
Senior Technical Manager  
Accounting Standards  
File 2354.WG  
American Institute of Certified Public Accountants  
1211 Avenue of Americas  
New York, New York 10036-8775

Dear Mr. Gill:

I am writing in support of deferring the effective date of a portion of the provisions of SOP 97-2 as proposed in the Statement of Position, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions*.

I am currently employed by a company which develops and sells software to the banking and finance industry. I find the provisions for vendor specific objective evidence as described in paragraph 10 of SOP 97-2 to be troubling and difficult to comprehend. The software products that we sell are in no way intended to be sold unbundled however we spend considerable time developing the price charged to customers for post contract support in year one and beyond. In our case, to deduct the PCS renewal rate from the bundled first year selling price to arrive at a value for the license is logical and historically consistent with our past practices.

The result from implementation of SOP 97-2 without modifying paragraph 10 will require that we change our business practice to avoid deferral of license revenue. This will be confusing to our customers and will not improve the accuracy of our financial reporting.

I strongly support the delay in certain provisions of SOP 97-2 and also the modification of paragraph 10 which would then allow PCS to be deducted from the selling price to arrive at a license revenue amount.

Sincerely,

Robert A. Moore, Jr.  
Controller



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■ 1285 Avenue of the Americas  
New York, New York 10019

■ Phone: 212 773 3000

February 25, 1998

FEB 26 1998

Mr. Frederick Gill  
Senior Technical Manager  
Accounting Standards  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036-8775

Proposed Statement of Position  
“Deferral of the Effective Date of Certain Provisions of SOP 97-2,  
Software Revenue Recognition, for Certain Transactions”  
File 2354.WG

Dear Mr. Gill:

We support the issuance of the above-referenced proposed Statement of Position because it provides a practical solution to an unintentional result of applying the provisions of SOP 97-2 with regard to certain software transactions involving multiple element arrangements.

We understand that AcSEC is considering forming a standing sub-committee to deal with reporting issues of technology companies, including, among other things, implementation issues relating to SOP 97-2. We believe this action should be taken, particularly because we are already aware of many implementation issues that are arising related to SOP 97-2 that may warrant additional guidance as the industry gains experience with the SOP. Addressing these issues timely is made more difficult given the short time frame between the issuance and effective date of SOP 97-2. To minimize diversity in practice, we strongly believe every effort should be made to develop and issue implementation guidance for the SOP as soon as possible.

We appreciate the opportunity to present our views on the proposal and would be pleased to discuss our letter with AcSEC or the AICPA staff at your convenience.

Very truly yours,

*Ernst & Young LLP*



#4

**Deloitte &  
Touche LLP****FEB 27 1998**

Ten Westport Road  
P.O. Box 820  
Wilton, Connecticut 06897-0820

Telephone: (203) 761-3000

February 26, 1998

Mr. Frederick Gill  
Senior Technical Manager  
Accounting Standards Division  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036-8775

**File Reference 2354.WG**

**Deferral of the Effective Date of Certain Provisions of SOP 97-2 for Certain Transactions**

Dear Mr. Gill:

We are pleased to comment on the Exposure Draft of a Proposed Statement of Position, Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions ("Exposure Draft"). We support the issuance of the Exposure Draft as a final Statement of Position ("SOP") with the modifications suggested below.

Because of the limited exposure period and due process applied to this Exposure Draft, the final SOP should be limited only to defining the scope of the SOP and the deferral of the effective date. It should not provide new guidance. Accordingly, the final SOP should not include the requirement in paragraph 4 of the Exposure Draft that the evidence of fair value of the service must be based on sales of the same service to the class of customer that is purchasing the multiple-element arrangement that includes software. The concept of a "class of customer" is not defined in SOP 97-2 or in its predecessor, SOP 91-1; therefore, the introduction of this term in this SOP would represent new guidance.

AcSEC should clarify the applicability of the proposed SOP to arrangements that include multiple software products and services or postcontract support (PCS). For example, consider an arrangement that includes PCS and two software products that are never sold separately from PCS. Vendor-specific objective evidence of fair value exists for the PCS element. It may not be clear that the proposed SOP would apply to this arrangement, given that there are two software products with indeterminable individual fair values. However, once both

**Deloitte Touche  
Tohmatsu  
International**

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Mr. Frederick Gill  
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software products have been delivered, revenue attributable to the two delivered software products combined (i.e., the software element) would be determinable, for example, under the differential measurement method, and should be recognized.

We share AcSEC's concern regarding the unintended change in practice that would occur as a result of applying paragraph 10 of SOP 97-2 to the types of multiple-element arrangements described in paragraph 4 of the proposed SOP. However, although the narrow scope established in paragraph 4 is a reasonable approach for this SOP, AcSEC should consider how it should go about providing guidance on other SOP 97-2 implementation issues.

If you have any questions concerning our comments, please contact John Smith at (203) 761-3199 or Naomi Erickson at (203) 761-3138.

Yours truly,

*Deloitte & Touche LLP*

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FEB 27 1998

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February 27, 1998

Mr. Frederick Gill  
Senior Technical Manager, Accounting Standards  
AICPA  
1211 Avenue of the Americas  
New York, NY 10036-8775

Re: File 2354.WG: Proposed Statement of Position "Deferral of the Effective Date of Certain Provisions of SOP 97-2, *Software Revenue Recognition*, for Certain Transactions"

Dear Mr. Gill:

I support efforts to repair the theoretical dilemma posed by the literal application of the words in SOP 97-2 to the transactions within the scope of the proposed amendment. However, the dilemma is more readily solved by a Practice Bulletin to aid preparers in interpreting how to apply SOP 97-2. Preparers and users of financial statements are poorly served by continuing the uncertainty of what the accounting rules for software are after years of debate that led to SOP 97-2.

The intention of SOP 91-1, the predecessor to SOP 97-2, was that the service element be unbundled based on the separate price of the service when it is sold separately, even if it is not sold separately as part of the initial software license. Refer to SOP 91-1 paragraphs 118 as to PCS and 113 as to other service transactions. Some judgment might be necessary, but exercise of such judgment was considered appropriate. There was no intent to change those basic conclusions when the "vendor specific objective evidence" criterion was introduced and adopted by the Software Task Force (of which I was a member), and I am not aware of any intent to change them by the Software Revenue Recognition Group. The change introduced by the new criterion was to deal with situations where the PCS or services were not sold separately by the vendor, so the vendor had to look outside its own specific pricing practices for the pricing.

The Exposure Draft discusses the allocation vs. differential measurement quite extensively. The differential measurement might be more appropriate if the software

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license and initial PCS (or other services) is never sold separately, but it is unlikely that the results of either accounting method applied consistently would vary materially over time, and I do not believe that it is AcSEC's role to deal with minutia at that level.

Therefore, a Practice Bulletin stating that PCS or services similar to those bundled with the initial software license sold separately in later periods or to other customers are "vendor specific objective evidence" would solve the issue at hand, be consistent with conclusions that led to SOPs 91-1 and 97-2, and better serve the interests of financial statement preparers and users by putting the issue to rest. I believe it is also consistent with the preponderance of current practice, which practice has achieved general acceptance by preparers and their auditors.

\* \* \* \* \*

I would be pleased to discuss my comments, or other aspects of the proposed SOP, with AcSEC or the Working Group.

Very truly yours,



Francis J. O'Brien



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FEB 27 1998

February 26, 1998

Mr. Fredrick Gill  
Senior Technical Manager  
Accounting Standards, File 2354-WG  
AICPA  
1211 Avenue of the Americas  
New York, NY 10036-8775

The Committee on Accounting Principles of the Illinois CPA Society ("Committee") is pleased to have the opportunity to comment on the Proposed Statement of Position - Deferral of The Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, For Certain Transactions ("ED") of the Accounting Standards Executive Committee ("AcSEC") of the American Institute of Certified Public Accountants. The organization and operating procedures of the Committee are reflected in the Appendix of this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any of the members of the Committee and of the organizations with which they are associated.

The Committee supports AcSEC and its decision to delay the effective date to December 15, 1998 of paragraph 10 of SOP 97-2 Software Revenue Recognition.

We would be pleased to discuss our comments and recommendations with members of the Software Revenue Recognition Working Group or staff of the Accounting Standards Division.

Very truly yours,

*Wayne Shust*

Wayne J. Shust, Chair  
Accounting Principles Committee

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APPENDIX

ILLINOIS CPA SOCIETY  
ACCOUNTING PRINCIPLES COMMITTEE  
ORGANIZATION AND OPERATING PROCEDURES

1997-1998

The Accounting Principles Committee of the Illinois CPA Society (the Committee) is composed of 25 technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to 20 years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions, representing the Society, on matters regarding the setting of accounting principles.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting principles. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which, at times, includes a minority viewpoint.

**Price Waterhouse LLP**



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**FEB 27 1998**

February 23, 1998

Mr. Frederick Gill, CPA  
Senior Technical Manager, Accounting Standards  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, New York 10036-8775

Dear Mr. Gill:

**File 2354.WL**  
**Proposed Statement of Position, Deferral of the**  
**Effective Date of Certain Provisions of SOP 97-2,**  
***Software Revenue Recognition,***  
**for Certain Transactions (Proposed SOP)**

We support issuance of the Proposed SOP. We suggest the two changes described below.

- **Reasonable Method.** We believe the words "... the portion of the sales price allocable to the software element... may be based on a reasonable method" in the conclusion described in the second sentence of paragraph 5 suggests that an "unreasonable" method also may be used. We do not believe this was AcSEC's intent. We suggest that the above-cited language be changed to "... *any* portion of the sales price allocable to the software element ... *is to* be based on a reasonable method." We understand that despite this change in wording, some enterprises with transactions within the scope of paragraph 4 may defer revenue from the delivered software element based on the absence of vendor-specific objective evidence of fair value for each element (paragraph 10 of SOP 97-2), because they believe that the SOP 97-2 method is a reasonable method, while others may recognize revenue for the software element based on another reasonable method of revenue allocation. We believe this resulting diversity should be addressed as discussed in the recommended change below under the heading "Disclosures." As a consequence of the wording change above, the last sentence of paragraph 5 should read: "If one were to conclude that \$750 determined pursuant to differential measurement represents a reasonable amount to allocate to the software element, such amount would be recognized as revenue when all of the other criteria for revenue recognition outlined in paragraph 8 of SOP 97-2 are met."

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- **Disclosures.** The proposed SOP does not require any disclosures by enterprises affected by the deferral of certain provisions of SOP 97-2. The proposed SOP allows enterprises to base their determination of the portion of the sales price allocable to the software element on "a reasonable method." Reasonable methods may vary and therefore, this provision will temporarily allow some diversity in practice. If a method other than the one included in SOP 97-2 is used by an SEC registrant the reporting obligations imposed by Staff Accounting Bulletin No. 74 (SAB 74) will likely result in disclosure of the impact of the expiration of the one year deferral on their reported operations. Non-public enterprises will not have similar reporting obligations. Additionally, SAB 74 disclosures are sometimes not in the financial statements. We suggest that the proposed SOP require that enterprises affected by this SOP disclose the method followed to determine the portion of the sales price allocable to the software element. This disclosure need only occur in the first reporting period for which financial information is presented after release of the proposed SOP and in any complete financial statements issued for periods ending on or prior to the end of the deferral period.

We would be pleased to respond to any questions you might have regarding our comments. Please contact H. John Dirks at (415) 393-8735.

Very truly yours,

*Price Waterhouse LLP*



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FEB 27 1998

Microsoft

February 26, 1998

Mr. Frederick Gill  
Senior Technical Manager, Accounting Standards  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036

**Re: Proposed amendment to Statement of Position (SOP) 97-2, *Software Revenue Recognition***

Dear Mr. Gill:

I am pleased to comment again on the overall conclusion of SOP 97-2 and in particular, its provisions regarding revenue attribution in transactions with deliveries of multiple elements including computer software.

**The effective date of SOP 97-2 should be extended for one year for *any* multiple-element arrangements for which separate prices are not available for every element. Paragraph 10 of SOP 97-2 should be amended to provide a framework for logical allocation of revenue to each element to match the recognition of revenue with the delivery of such elements.**

The overarching conclusion of SOP 97-2 to unbundle the fair values of multiple elements of a transaction and recognize the allocated revenue as or when the related element is delivered is a fundamental and logical accounting principle. Deviations away from this basic concept cause a disconnect of recognition of revenue from the delivery of goods or services. For example, full upfront recognition for transactions with undelivered obligations overstates revenue in the current period and understates revenue in subsequent periods. Likewise, full deferral of revenue for transactions under which fully functional software has been delivered but support or services have yet to be delivered understates current period revenue while overstating revenue in subsequent periods. Recent informal and unauthoritative interpretations of Paragraph 10 of SOP 97-2, and the misplaced conclusion of the proposed amendment of SOP 97-2 undermine the basic concept of aligning revenue recognition with proportional performance. The new SOP for software revenue recognition needs to reinforce the concept of properly matching revenue recognition with delivery without forcing illogical deviations.

Perhaps as a consequence of pursuing the idealistic goal of reducing the level of judgement involved in measuring revenue, SOP 97-2 is too granular. Detailed rules that may address a majority of identified issues of today are undoubtedly going to be obsolete tomorrow. The software environment is particularly dynamic. This industry is too complex and it changes too rapidly for detailed accounting guidance and examples in authoritative pronouncements to be effective. Companies' products, strategies, and relationships change overnight. New types of license agreements, delivery mechanisms, and distribution channel relationships are created daily. The Internet is generating an entirely new model of customer relationships, in that subsequent delivery of product enhancements and support is pervasive and is becoming an integral mode of operation. In this environment, can detail accounting rules survive? No. But can accounting frameworks survive and be effective? Certainly. Frameworks of basic accounting rules should guide preparers and auditors of financial statements. SOP 97-2 is obviously an improvement over SOP 91-1 in that it represents a step in the direction of an accounting framework rather than a collection of answers to yesterday's issues. But remnants of granularity still remain. The

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computer industry doesn't need an amended SOP with even more issue-specific guidance. We need a framework that is based on the concept of recognizing revenue when it is earned.

Paragraph 10 of SOP 97-2 is a perfect example of too detailed guidance. The concept that an arrangement's fee should be allocated to the various elements based on their fair value is undeniably logical and appropriate. However, the level of guidance as to the required level of objectivity of "evidence" of fair value is incredibly detailed and causes more harm than good. Readers of SOP 97-2, particularly auditors, are caught up in trying to determine what exactly qualifies for the proper "evidence" of fair value. I'm afraid this is an example of not being able to see the forest for the trees, and the proposed amendment would actually move more companies away from matching the recognition of revenue with the delivery of the various elements. In many instances, literal interpretations of the SOP will force companies to defer revenue in full, thus overstating revenue in future periods. Perhaps another unintended consequence would be for companies to take the position that if full deferral is the wrong answer and recognition on the basis of proportional performance is specifically prohibited by the SOP, and thus the default is full upfront recognition. Such a case would be a terrible consequence, particularly since one of the perceived abuses cured by SOP 91-1 was full upfront recognition of software licensing arrangements, even though the software vendor was obligated for future deliveries.

So instead of attempting to clarify the notion of allocating revenue to elements based on only a subset of practice issues, the amended SOP should require companies to determine the portion of the sales price allocable to *all* elements based on a reasonable method. This logical accounting is consistent with other elements of financial statements, consistent with accounting followed by other industries, and *consistent with AcSEC's conclusion in the proposed amendment for transactions in which the "service" element has a separate sales price.*

It is interesting to note that many computer companies sell computer systems with software that is bundled in the arrangement, embedded in the microprocessor, or included as firmware. Consider the situation where the computer company does not sell the software or support separately but has a history of providing free support or subsequent software enhancements. Under a literal interpretation of SOP 97-2, one could conclude that no revenue could be recognized until every element is delivered or perhaps the entire fee (including the value of the computer) should be recognized ratably over the support period. This answer would not be logical but it could be inferred from the proposed language in the amended SOP.

The proposed SOP would allow the "with and without" method of allocating revenue between multiple element arrangements if the "service" element is separately priced but the software is never sold separately. Thus the value derived for the software would be recognized upon delivery of the software and the value of the support or service would be recognized as that obligation is performed. However, it appears that if the software has a separate price but the "service" element is never sold separately, then the entire fee must be recognized over the period the service is performed. Note that software represents the majority of the value for most arrangements, and it is not uncommon for companies to sell the software separately but not sell the support element separately. Thus companies would face the following conundrum. If a price were established for only the service (say 20% of the value) the company would have a logical revenue model. But if only the software element had a separate price (say 80% of the value), the entire fee would be deferred and recognized over the period of the support. It would be unfortunate to have an accounting rule where so called vendor specific objective evidence of only 20% of the value led to an appropriate matching of revenue with delivery, but evidence of 80% of the value did not qualify for the appropriate accounting. This could be viewed as the tail wagging the dog.

The above situation seems to be driven by confusion over discounts. Please note that Paragraph 104 of SOP 97-2 requires that discounts be allocated to each element based on the relative fair

#8

values of the elements. Fears of companies inappropriately allocating discounts to various elements should not be a basis for an obviously bad accounting rule.

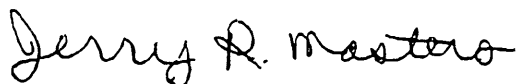
Also, there is a parallel issue of valuing the elements of a software license arrangement from the perspective of the purchaser. The proposed SOP for internal use software requires companies that purchase maintenance with software to estimate the value of the maintenance and exclude that value from the capitalization of the software. Its ironic that companies purchasing multiple element arrangements are required to use their judgement to allocate the cost of the transaction between the software and the support. One source of information for that decision would be to ask the software vendor to provide the allocation of the value of the software for capitalization and the value of the support for directly recording expense. It would be doubly ironic if the vendor didn't sell the software separately and had to defer all revenue while the purchaser would record the other side of transaction on a logical basis, based on the *vendor's judgement* of the relative values of the elements.

Importantly, the needs of users of financial statements should be addressed. A revenue model that doesn't match recognition with delivery will cause unwarranted confusion. Users want logical and understandable methods, not complex rules that produce irrational results.

In conclusion, we need to amend Paragraph 10 so that the concept of proportional performance drives revenue recognition, not whether or not a certain element is sold separately for a separate price.

I look forward to working with you to provide the software industry with a logical framework of matching revenue with delivery.

Sincerely,



Jerry R. Masters  
Senior Director, Planning and Reporting

JRM/lab



February 25, 1998

#9  
FEB 27 1998

Mr. Frederick Gill  
Senior Technical Manager  
Accounting Standards  
File 2354, WG  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036-8775

Re: Exposure Draft, Deferral of the Effective Date of SOP 97-2

Dear Mr. Gill:

Software  
Publishers  
Association

This letter represents the comments of the Software Publishers Association (SPA) to the Exposure Draft issued on February 11, 1998. This Exposure Draft proposes to defer the effective date of a portion of SOP 97-2, Software Revenue Recognition. The purpose for such delay is to afford AcSEC time to further study certain issues that were not considered by AcSEC during its initial deliberations. SPA supports your proposal to defer the effective date of SOP 97-2 and to further study the issues. However, we believe that the scope of the deferral and proposed study topic is too narrow and should be expanded.

SPA is the principal trade association of the computer software industry, representing the leading publishers as well as start-up firms in the business, home-office, consumer, entertainment and educational markets. SPA supports companies that develop and publish software applications and tools for the desktop, client-server networks, and the Internet. SPA's 1,200 member companies account for 85 percent of U.S. revenues for packaged and on-line software.

The Exposure Draft proposes to delay the effective date of that portion of paragraph 10 of SOP 97-2 that gives guidance on what constitutes vendor-specific objective evidence of the fair value of the software element in certain multiple-element transactions that include either service or post-contract support elements, or both. Specifically, the Exposure Draft applies:

only to multiple-element arrangements in which (a) a software element is sold *only* in combination with post-contract customer support (PCS) or other service element(s) that qualify for separate accounting pursuant to SOP 97-2, or both, and (b) there is vendor-specific objective evidence of the fair value of each of the service elements determined pursuant to paragraphs 10, 57, and 65 of SOP 97-2. The evidence of fair values(s) of each of the service element(s) must be based on sales of the same service to the class of customer that is purchasing the multiple-element arrangement that includes the software element.

The Exposure Draft recommends that effectiveness of this portion of SOP 97-2 be delayed so that a new SOP can be drafted that provides additional guidance on these issues.

In arriving at its conclusions for SOP 97-2, AcSEC did not deliberate situations in which software would always be sold with PCS or other service elements, *or vice versa*. In such situations, there could be vendor-specific evidence of the fair value of *either* the services or the software when sold separately (for example, by reference to renewal PCS, the price for user training that is sold separately, *or the software if licensed without PCS or service*). Application of paragraph 10 of SOP 97-2, however, would result in a determination that there was no vendor-specific objective evidence of the fair value of the element that is not sold separately, whether software, PCS or service. Application of the provisions of paragraph 12 of SOP 97-2 would result in the deferral of all revenue from such transactions.

The Exposure Draft suggests that a differential measure method might be used to estimate fair value in those situations. AcSEC is concerned that use of a differential method might lead to over-allocation of discount to the non-delivered element. Thus, the Exposure Draft limits the deferral of the effective date of paragraph 10 of SOP 97-2 only to those situations where the software is not sold separately and a price for the renewal PCS or other service can be determined. In such situations, all of the discount would be allocated to the software, which has been delivered, and none of the discount would be allocated to the non-delivered renewal PCS or service component. This results in under-allocation of discount to the non-delivered element, the renewal PCS or service. This also results in under-recognition of revenue in the year the software is delivered and over-recognition of revenue in the year the services are delivered.

In those cases where renewal PCS or services are never sold without software, but software is sold separately, a separate price for the software, which is delivered immediately, is known. If the differential method were used in this circumstance it would result in all of the discount being allocated to the non-delivered element, the renewal PCS or service. This might result in more revenue recognition in the year the software is delivered and less revenue recognition in the year the renewal PCS or service is delivered.

The Exposure Draft does not propose to defer the effectiveness of paragraph 10 of SOP 97-2 in those cases where renewal PCS or service is never sold without software, but a separate price for the software is available. The result is that all of the revenue from such transactions would be deferred. This results in a gross under-recognition of revenue in the year of delivery of the software, and a gross over-recognition of revenue in the year the renewal PCS or service is delivered. SPA believes that this conclusion flies in the face of the admonition of Financial Accounting Concept 2, paras. 95 and 96, which provide, in pertinent part, as follows:

#9

Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available .....

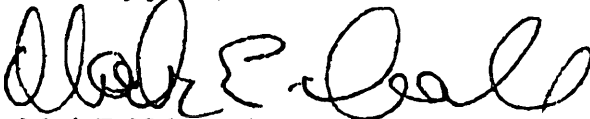
[A]ny attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long-run. That kind of reporting, however well-intentioned, is not consistent with the desirable characteristics described in this statement ... Bias in estimating components of earnings, whether overly conservative or unconservative, usually influences the timing of earnings or losses rather than their aggregate amount. As a result, unjustified excesses in either direction may mislead one group of investors to the possible benefit or detriment of others.

AcSEC should recognize that the admonitions of Concept 2 are implicated just as heavily in circumstances not addressed by the current Exposure Draft.

AcSEC should delay the effectiveness of paragraph 10 of SOP 97-2 with respect to the other circumstance described in this letter and that such other circumstance be made a part of the further study. SPA believes that current proposal is too narrow; deferral of the effective date should be expanded to include all multiple arrangements covered by paragraph 10. If paragraph 10, as currently interpreted by AcSEC is not amended as we suggest above, the impact of SOP 97-2 on our industry will be harsh. Full deferral for these transactions is not appropriate accounting. Users of financial statements will not be served well by this confusing and contradictory rule.

SPA looks forward to working with AcSEC on these issues and stands prepared to provide any industry input that it can. I can be reached at (202) 452-1600 ext. 319 with any questions.

Sincerely yours,



Mark E. Nebergall  
Vice President and Counsel  
Software Publishers Association

ARTHUR  
ANDERSEN

#10  
FEB 27 1998

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Arthur Andersen LLP

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33 West Monroe Street  
Chicago IL 60603-5385

February 27, 1998

Mr. Frederick Gill  
Senior Technical Manager  
Accounting Standards  
File 2354.WG  
AICPA  
1211 Avenue of the Americas  
New York, NY 10036-8775

Dear Mr. Gill,

The attached letter sets forth our comments on the AICPA's proposed Statement of Position, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, "Software Revenue Recognition," for Certain Transactions.*

We appreciate the opportunity to comment on this proposed guidance.

Very truly yours,



Benjamin S. Neuhausen

# ARTHUR ANDERSEN

#10

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Arthur Andersen LLP

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33 West Monroe Street  
Chicago IL 60603-5385

February 27, 1998

Mr. Frederick Gill  
Senior Technical Manager  
Accounting Standards  
File 2354.WG  
AICPA  
1211 Avenue of the Americas  
New York, NY 10036-8775

Dear Mr. Gill:

We are pleased to have the opportunity to comment on the Exposure Draft (ED) of a Proposed Statement of Position, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, "Software Revenue Recognition," for Certain Transactions.*

We support issuance of the ED as a final SOP, and we support the associated AcSEC project to reconsider the application of paragraph 10 of SOP 97-2 to the specific transactions discussed in the ED. We recognize that applying paragraph 10 to these transactions may result in a greater change in practice than AcSEC intended.

We support the scope of the ED as proposed. We would not object to narrowing the scope to limit the service element(s) to PCS for a period of not more than one year. We believe that broadening the scope from what is proposed would be inappropriate, because SOP 97-2 is so recently issued.



#10

\*\* TOTAL PAGE.04 \*\*

#11

**Lucent Technologies**  
Bell Labs Innovations

February 26, 1998

American Institute of Certified Public Accountants  
Accounting Standards, File 2354.WG  
1211 Avenue of the Americas  
New York, NY 10036-8775  
Attention: Mr. Frederick Gill  
Senior Technical Manager

Catherine M. Carroll  
Financial Vice President &  
Assistant Controller

283 King George Road  
Room B3D23  
Warren, NJ 07059

Telephone 908 559 3160  
Facsimile 908 559 3944  
E-Mail: [mcatherine@lucent.com](mailto:mcatherine@lucent.com)

**FEB 27 1998****Re: Deferral of the Effective Date of Certain Provisions of SOP 97-2**

Dear Mr. Gill:

Lucent Technologies Inc. (Lucent) is pleased to submit its comments on the AICPA's Proposed Statement of Position entitled *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions* (Exposure Draft). Lucent is one of the world's leading designers, developers, and manufacturers of telecommunications systems, software, and products. Lucent had total assets of approximately \$24 billion as of September 30, 1997, and total revenues of approximately \$26 billion for the year then ended.

Lucent agrees with the objective of the Exposure Draft which is to defer the application of paragraph 10 of SOP 97-2 for multiple-element arrangements in which (a) the software element is sold only in combination with postcontract customer support or other service elements(s) that qualify for separate accounting pursuant to SOP 97-2, or both, and (b) there is vendor-specific objective evidence of the fair values of each of the service elements determined pursuant to paragraphs 10, 57, and 65 of 97-2. We strongly agree with the conclusion of the Exposure Draft that for purposes of applying the provisions of SOP 97-2, the portion of the sales price allocable to the software element should be based on a reasonable method. We feel that differential measurement or some other alternative method would provide for 1) more accurate reporting of software revenues and income and 2) a better reflection of matching software revenues and the associated amortized costs than would be achieved pursuant to the existing provisions of SOP 97-2 when vendor-specific objective evidence is not available for the software element.

Although we support the objective of the Exposure Draft, Lucent believes the scope should be expanded. As previously mentioned in our comment letter dated October 9, 1996, Lucent believes that it is difficult to comply with the vendor specific objective evidence requirements for software companies that do not market all of their software products and services separately. For these companies, the application of paragraph 10 and 12 of SOP 97-2 may result in 1) inaccurate reporting associated with delivered software elements meeting all other requirements for revenue recognition and 2) a departure from the basic matching principle. Considering current marketing practices

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**Lucent Technologies**  
**File reference 2354.WG**

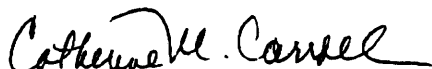
whereby software companies often do not sell individual contract elements separately, and the likelihood that these companies will be unable to determine the fair value for each element due to their marketing practices, we propose that AcSEC consider broadening the scope of the Exposure Draft to include transactions involving other elements (e.g. software licenses and hardware) beyond postcontract customer support and services.

Lucent agrees that fair value should be utilized as the sales allocation method when fair value information is available for each element, however the use of an alternative approach (e.g. the differential method) should not be limited to post contract support and services. The expansion of the Exposure Draft to other elements not only supports the basic matching of revenues and costs to when they are earned and incurred, it also provides a consistent valuation methodology for software revenue recognition regardless of the how the software is sold or bundled.

We appreciate your consideration of the points discussed in this comment letter. If you would like clarification of any points referred to in this letter, please feel free to call me at (908) 559-3160 or Dennis O'Brien at (908) 559-7705.

Thank you for your consideration of our comments.

Sincerely,



Catherine M. Carroll  
Financial Vice President &  
Assistant Controller

MAR 2 1998

February 26, 1998

Mr. Frederick Gill, Senior Technical Manager  
Accounting Standards  
File Reference 2354.WG  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, New York 10036-8775

**Proposed Statement of Position, "Deferral of the Effective Date of Certain  
Provisions of SOP 97-2 for Certain Transactions"  
(File Reference No. 2354.WG)**

Dear Mr. Gill:

We are pleased to provide comments on the proposed Statement referred to above. We have studied the Statement of Position 97-2 ("SOP 97-2") for "Software Revenue Recognition" in great detail. Based on the timing of the effective date and lack of implementation guidance provided, we believe that the proposed "Deferral of the Effective Date of Certain Provisions of SOP 97-2 for Certain Transactions" is necessary. As companies need sufficient time to evaluate the impact of the SOP on their business practices and to formulate plans for implementation, we strongly agree with the proposal to defer the effective date of a portion of the provisions of SOP 97-2 for certain transactions.

Our comments on specific aspects of the proposal specifically relate to provisions of paragraph 10 of SOP 97-2. Paragraph 10 of SOP 97-2 states that if an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value. Vendor-specific objective evidence of fair value is limited to: the price charged when the same element is sold separately or the price established by management having relevant authority to determine the probable price for an element not yet being sold separately.

Price charged when element is sold separately

The proposal requires that the license fee for multiple element arrangements be allocated based on vendor-specific objective evidence of fair value. Certain multiple-element arrangements include service elements that are offered by companies that never sell or plan to sell the software element separately. In such cases, the entire contract must be deferred under SOP 97-2 due to insufficient vendor-specific objective evidence, thus placing no value on the delivered software element in such arrangements. As stated in paragraph 15 of the proposed "Deferral of the Effective Date of Certain Provisions of SOP 97-2 for Certain Transactions", recognizing no revenue from the delivered software element would inappropriately understate reported revenue related to software and income in the period of initial delivery.

In cases where the service elements are offered for renewal at specified prices, we believe that adequate information exists to establish vendor-specific objective evidence for the service piece that enables revenue to be allocated among the various elements. We believe the reconsideration of the application of paragraph 10 of SOP 97-2 for situations in which software would always be sold with PCS or other service elements is appropriate. We believe this results in a more appropriate recognition of the transaction than to recognize no value for delivery of the core product element.

Symantec Corporation

10201 Torre Avenue  
Cupertino, California  
95014-2132  
408/253-9600  
Fax 408/253-4092

Page 1 of 2

Price established by for an element not yet being sold separately

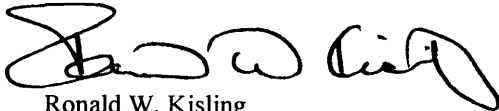
For multiple element arrangements where an element is not yet being sold separately, vendor-specific objective evidence of fair value is limited to the price for each element established by management having the relevant authority. The SOP 97-2 further states that it must be probable that the price, once established, will not change before introduction of the element into the market and that internally established prices should be factual and not estimates. Our concern with "probable" pricing is that it requires management to assess future events that are unpredictable. We believe historical pricing patterns provide an adequate basis for establishing probable future pricing which would allow revenue to be allocated among the various elements. Again, we believe this results in a more appropriate recognition of the transaction than to recognize no value for delivery of the core product element.

We recommend the adoption of the proposed SOP "Deferral of the Effective Date of Certain Provisions of SOP 97-2 for Certain Transactions" to allow adequate consideration of the above issues. We recommend the use of differential measurement to determine vendor-specific objective evidence in situations where software would always be sold with PCS or other service elements.

We also recommend that SOP 97-2 be modified to recognize historical pricing patterns as a basis for establishing "probable" future pricing for elements not yet being sold separately.

We appreciate the opportunity to present our views on the proposal. If you have any questions concerning our comments, please contact Cynthia Harrington at (408) 446-7476.

Sincerely,  
Symantec Corporation



Ronald W. Kisling  
Vice President, Controller

#13

Coopers  
& Lybrand

Coopers & Lybrand L.L.P.

a professional services firm

101 Hudson Street  
Jersey City, NJ 07302

MAR 3 1998

February 26, 1998

Mr. Frederick Gill, Senior Technical Manager  
Accounting Standards, File 2354.WG  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036-8775

Re: Proposed Statement of Position, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions*

Dear Mr. Gill:

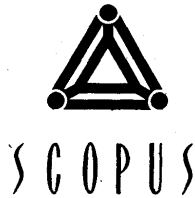
Coopers & Lybrand L.L.P. is pleased to comment on the proposed Statement of Position, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions* (the "proposed SOP"). We are aware of the concerns raised by many in the software industry regarding the impact of SOP 97-2 on revenue when vendors only sell software bundled with postcontract customer support (PCS) or other services. We believe that AcSEC, when determining the conditions under which deferral of all revenue over the life of a multi-element software contract would be required, did not consider the possibility that such treatment might be applied when software is always sold with services. For this reason, we support the issuance of the proposed SOP as well as the decision to reconsider the accounting for such arrangements.

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We appreciate the opportunity to comment on the proposed SOP. If you have any questions, please contact James F. Harrington at (201) 521-3039.

Very truly yours,

*Coopers & Lybrand L.L.P.*  
COOPERS & LYBRAND L.L.P.



#14

February 25, 1998

MAR 4 1998

Mr. Frederick Gill  
Senior Technical Manager, Accounting Standards  
American Institute of Certified Public Accounts  
1211 Avenue of the Americas  
New York, NY 10036

Re: Proposed Amendment to SOP 97-2

Dear Mr. Gill:

I am pleased to comment on behalf of Scopus Technology on the overall conclusion of SOP 97-2 and its provisions related to revenue recognition of the transaction involving the delivery of multiple elements. We believe the effective date of paragraph 10 of SOP 97-2, which limits vendor specific objective evidence to situations where each element is separately sold, should be extended for one year.

While we support completely the conclusion that a software vendor should account for each element of its transaction using vendor specific objective evidence in determining the fair value of each element, a literal interpretation of paragraph 10 of SOP 97-2 as written could result in conclusions that are in our view, unreasonable.

We support the issuance of the ED as proposed, however we believe the scope should be expanded to address all multiple elements and should not be limited to those specified in the ED that was circulated for comments.

Very truly yours,

Michele L. Axelson  
Senior Vice President and CFO

MLA/smd

*Comment Letters*

**A Team AICPA Note**

For Reference  
Do Not Take  
From the Library



DATE: March 17, 1998  
TO: Library  
FROM: Fred Gill *F. Gill*  
SUBJECT: Comment letters on the exposure draft to amend provisions of SOP 97-2

Enclosed are copies of the comment letters received on the February 11, 1998 exposure draft, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions.*

Please make these letters available for public inspection for a period of one year beginning on March 30, 1998.



*Comment Letters*

For Reference  
Do Not Take  
From the Library

March 2, 1998

To the Accounting Standards Executive Committee

**File 2354.WG**

Enclosed for your information are copies of the 11 comment letters received through 10:30 a.m. on Monday, March 2, 1998 on the February 11, 1998 exposure draft, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions*.

Sincerely,



Frederick Gill, CPA  
Senior Technical Manager  
Accounting Standards

FG:fg  
Enclosures